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Low Inflation: Good News for Commercial Real Estate?



By Wayne E. Etter and Harold D. Hunt

The Federal Reserve Board of Governors (Fed) has made one thing abundantly clear during the past several months—inflation will not be tolerated. Recently, the Fed attacked the possibility of future inflation even though many outsiders argue that little present evidence indicates that strong inflationary pressures are developing. Even the possibility of strong inflationary pressures developing at a future date, however, has caused the Fed to raise interest rates with the objective of slowing economic growth and maintaining price stability.

A traditional benefit of owning real estate is its role as a hedge against inflation. During inflationary periods, increasing real estate values are expected to keep pace with inflation. Investors who own real estate presumably do not need to fear inflation as would bond and mortgage investors; the value of outstanding bonds and mortgages declines when market interest rates rise in response to expected inflation.

Long-run commercial real estate values are determined by supply-and-demand conditions within their particular market area. In a market where increased demand for space relative to supply exists (or is expected), market rental rates will increase; however, during inflationary periods, rental rates also may increase because of specific commercial lease clauses that link rental rates to the inflation rate. Over time, increased rental rates from either source will be capitalized into

increased real estate values. Thus, during recent years, commercial property values have increased from both the greater demand for space and the effects of inflation.

If the effects of supply and demand on property values were set aside, how might real estate values be affected during a period of little or no expected inflation? In particular, how might a sustained noninflationary period affect the value of commercial real estate?

Effects on Net Operating Income

Because *pro forma* projections of net operating income (NOI) have a fundamental role in estimating a property's value, the impact of little or no inflation on NOI is considered first. In the simplest terms, a property's net operating income is calculated as follows:

Potential gross income	\$100,000
Less: Vacancy and collection loss	<u>-5,000</u>
Effective gross income	\$ 95,000
Less: Operating expenses	<u>-35,000</u>
Net operating income	\$ 60,000

Commercial property leases can be designed to protect the owner (and the tenant in some cases) from the adverse effects of inflation. In particular, these leases can address the effect of expected inflation on potential gross income and operating expenses.

For example, some leases contain escalation clauses that specify periodic increases in a tenant's rent, while others base the amount of the periodic increase on the CPI or some other price index. Many retail property leases contain percentage lease clauses that define the tenant's rent as the greater of a fixed minimum rent or a specified percentage of sales.

As the retailer's sales increase beyond the break-even point (i.e., fixed minimum rent equals the specified percentage of sales), their rent increases. In some leases, the retailer's sales increases caused only by inflation (i.e., the same quantity of goods sold but at higher prices) are offset by periodic raises in the fixed minimum rent, but the effect is the same. Escalations in the fixed minimum rent may take place according to an agreed schedule, or they may be linked to the CPI.

Without terms such as these, commercial property owners would be reluctant to enter into long-term leases with tenants. Tenants are willing to accept these terms because a long-term lease allows them to capture the benefit of maintaining their business presence at a preferred location; presumably, they believe that a rental rate increasing approximately at the inflation rate is a fair price to pay for this benefit.

Owners insulate themselves from operating expense increases through the use of leases with expense stops or triple-net leases. These arrangements vary, but for the owner, the objective is either to limit the amount of operating expenses they pay (any excess of actual operating expenses more than the expected amount will be paid by the tenant) or to pass all operating expenses except management and leasing expenses through to the tenant. For their part, tenants often demand lease clauses that limit the annual percentage increase in operating expenses for which they will be responsible.

Accordingly, during periods of inflation many commercial property owners receive increasing rental income over time with either limited or no exposure to increasing operating expenses. Because management and leasing expenses are a percentage of collected rent and expected rental income, respectively, they normally increase only as income increases. Thus, during periods of inflation these lease terms produce increasing NOI for the property owner.

During the inflationary environment of the last few years, commercial property leases have protected property owners from inflation and, therefore, have been the incentive for tenants to enter into long-term leases. But during a period with little or no expected inflation, will tenants agree to higher rental rates when current leases expire and/or the fixed minimum rent periodically increases? Tenants may agree to these terms for those locations having a high demand, but when property owners compete for tenants, their agreement is less likely. Thus, in the absence of inflation, the supply and demand for space will become the predominant factor in properties' ability to generate increasing NOI. (Of course, according to the terms of their percentage leases, retail tenants that experience an increase in the quantity of goods sold will pay higher rent.)

Effects on the Property's Value

Real estate's role as an inflation hedge is more dependent on its potential for increased value than for its current income. A property's value is a function of its expected income. When investors estimate a property's value (to compare to its cost or offering price), they take the property's projected income into account whether they use the income capitalization approach or a discounted cash flow (DCF) model. With either model, a reduced income expectation will reduce the investor's estimate of the property's value, if all other things are equal. The DCF model is the most useful for understanding how this takes place.

When a DCF model is used to estimate a property's value (without consideration of debt or income taxes), the property's estimated current value is equal to the present value of

expected NOI during the holding period plus the present value of its future resale price.

To estimate a property's resale price five or ten years into the future, the property's NOI is estimated for the year following the expected resale; this estimated NOI is capitalized using the terminal capitalization rate that future investors are expected to be using at the time of the resale. Most NOI estimates are not perfect, but if, at the time of the estimate, the estimate is believed to be reasonable it will be used to establish the property's current value.

Usually when this calculation is reviewed, most of a property's estimated current value may be attributed to the property's projected resale proceeds. In the following illustration, for example, the property's resale proceeds contribute approximately 64 percent of the property's total value

Year	NOI if growth rate is 3%	Resale	Present value at 10%
1	\$60,000		\$54,545
2	61,800		51,074
3	63,654		47,824
4	65,564		44,781
5	67,531		41,931
5		\$695,564	<u>431,891</u>
	Estimated value of property		\$672,046

The critical point is that if the estimator currently believes that NOI will increase little or none over the holding period, then little or no property appreciation will be forecast unless current investors lower their required rate of return or future investors lower their capitalization rate. There is little reason to believe that current investors will pay a higher price for a property when its appreciation potential is reduced. In fact, it seems likely that current investors would pay less for NOI given its slight potential for appreciation. In the following example, the present value of the property's resale value contributes 63 percent of the property's current estimated value, but because NOI increases only 1 percent per year, the property's value declines to \$623,160, a reduction of \$48,887 or 7.3 percent.

Year	NOI if growth rate is 1%	Resale	Present value at 10%
1	\$60,000		\$54,545
2	60,600		50,083
3	61,206		45,985
4	61,818		42,223
5	62,436		38,768
5		\$630,606	<u>391,557</u>
	Estimated value of property		\$623,161

Many commercial leases provide the owners with rising NOI during inflationary periods; these same lease terms will produce a much smaller increase in NOI during a period of little or no inflation. Thus, if the Fed's efforts to control inflation are successful for a sustained period, the value of commercial real estate is unlikely to increase over time without an increased demand for space relative to supply. ☐

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